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IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, a Corporation,
Appellant,

vs.

THE UNITED STATES,
Appellee.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF FOR APPELLANT.

EDWARD B. BURLING,
CHARLES MCCAMIC,
JAS. MORGAN CLARKE,
Counsel for Appellant.

Press of Byron S. Adams, Washington, D. C.

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No. 453.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF FOR APPELLANT.

STATEMENT OF THE CASE.

This is an appeal from a judgment of the Court of Claims sustaining a demurrer of the United States and dismissing the claimant's petition. The suit was brought to recover a sum alleged to have

been erroneously collected under Title II of the Revenue Act of 1917, imposing a tax on excess profits, and involves the construction and constitutionality of that law, particularly the provisions by which the amount of the tax is measured by the "invested capital" of the taxpayer.

The Statute.

Title I of the Act of October 3, 1917, 40 Stat., 300, cited as the "Revenue Act of 1917", provided for the taking as an income tax of a certain percentage of incomes of individuals and corporations. Title II provided for the levying of an excess profits tax on individuals and corporations. The theory of this excess profits tax was that, after allowing a fair return of not less than 7 per cent nor more than 9 per cent upon invested capital, all the balance of the income (assumed to be *excessive* profits) should be subject to a heavy "excess profits tax", the rate running up to 60 per cent. The portion of the income which was subject to the excess profits tax was thus directly determined by the amount of the invested capital. If the invested capital of the taxpayer was sufficiently large so that the income was no more than a fair return on it, then no portion of the income was subject to the excess profits tax and no excess profits tax was to be paid. It was thus important to every corporation to have included in its invested capital all items which could rightly be included under the language of the whole Act.

The *invested capital* not only determines the deduction or the amount of the income which is free from the excess profits tax, but determines also the rate of tax which the *remainder* of the income is to bear. Thus, a corporation pays 20 per cent of its net income in excess of the statutory deduction and not in excess of 15 per cent of its invested capital, it pays 25 per cent of its net income in excess of 15 per cent and not in excess of 20 per cent of its invested capital, and so on at increasing rates up to 60 per cent of its net income in excess of 33 per cent of its invested capital. This results in a complication of figures, and for the sake of clearness of expression the references to the effect of invested capital hereafter given in this brief relate only to the amount of the deduction for invested capital purposes. But it should be borne in mind that the difference in the *rate* of tax depending on the amount of invested capital is just as important to the taxpayer as the amount of the deduction.

Invested capital is only partially defined in Section 207 of the Act. It is there stated that the term "invested capital" includes:

> "(1) Actual cash paid in.
>
> (2) The actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first,

nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and

(3) Paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: * * ***

There is no definition in the Act of "paid in or earned surplus and undivided profits."

The Facts.

The facts are admitted by the demurrer.

La Belle Iron Works, a corporation organized in 1875 in West Virginia (Rec., p. 1), acquired ore lands prior to the year 1904 for the sum of $180,000; extensive explorations and development work were carried on, and it was proved that the lands contained large bodies of ore. Between 1904 and 1912 the property increased in value, and the actual cash value of the ore properties in 1912 was not less than $10,105,400, and at all times from 1912 to 1917 the actual cash value of the ore properties was not less than $10,105,400. (Rec., p. 4.)

In 1912 the Company capitalized the ore properties on its books at $10,105,400. (Rec., p. 4.) Thereupon in said year, 1912, the old stock con-

sisting of a par value of $9,915,400 all of one class was called in, the charter was amended fixing the authorized issue at $10,000,000 par value of common stock and $10,000,000 par value of preferred stock; all the old outstanding stock was surrendered by the stockholders to the Company and cancelled, and each stockholder received in exchange one share of the new common stock and one share of the new preferred stock in place of each share of the original stock outstanding. (Rec., p. 5.)

The Company made a return for the year 1917 in which it showed its "invested capital" to be $26,322,904.14, which included said ore lands at the sum of $10,105,400, and upon said return paid an income and excess profits tax of $5,139,109.84. (Rec., p. 4.) Thereafter the Commissioner of Internal Revenue caused to be made a reassessment of the said tax for said year and assessed an additional tax of $1,081,184.61, which tax was arrived at by reducing "the invested capital" to $16,407,507.14, by striking out the increase in the value of the ore lands, $9,915,400. (Rec., p. 5.)

Said additional tax was paid on February 24, 1920, under duress and protest, and is the amount sued for. (Rec., p. 5.) Claimant filed a claim for refund on March 17, 1920, which was denied on April 8, 1920, by the Commissioner. (Rec., p. 6.)

Questions Involved.

The question raised by the claimant's petition and the Government's demurrer is whether the claimant in making its excess profits tax return for the year 1917 was entitled to include in invested capital a sum not exceeding the actual cash value at all times after January 1, 1912, of its ore bodies, that is, $10,105,400.

First: The claimant contends that the $9,915,400 increased value of the ore properties, which sum was placed on the Company's books in 1912, is legitimately to be included as invested capital under the clause in Section 207 (a) (3) above quoted, that is, "paid in or earned surplus and undivided profits".

Second: The next contention of the claimant is based on the peculiar facts of this particular case and perhaps might not apply to any company but La Belle Iron Works. This point is that within clause (2) which provides that invested capital shall include the "actual cash value of tangible property paid in other than cash for stock", the stock of the Company issued in 1912 consisting of $9,915,400 preferred stock, and $9,915,400 common stock, a total of $19,830,800 was fully paid for: (a) by the tangible assets including the ore properties at their increased value, or (b) by the surrender of all the certificates representing all the old common stock which had an actual cash value equal to $19,830,800.

Third: The claimant contends that the construction put upon the Act by the Department by which the taxation is based not upon value but upon the single feature of cost, no matter what the year of acquisition (the cost in this case being less than 2 per cent of values established in 1912 and ever since maintained), would render the Act unconstitutional as a deprivation of property without due process under the Fifth Amendment. The claimant does not contend that the provisions requiring uniformity and apportionment apply. The constitutional argument is based squarely on the proposition that taxation based on the cost of property, ignoring actual values, is so arbitrary as to amount to confiscation and is therefore contrary to the due process clause within the doctrine of Gast Realty & Improvement Company vs. Schneider Granite Company, 240 U. S. 55. Since the Act is of doubtful construction, the Department's construction, which would render it unconstitutional should be avoided.

SPECIFICATION OF ERRORS

1. The Court of Claims erred in sustaining the defendant's demurrer to the petition.

2. The Court of Claims erred in entering judgment dismissing the petition.

ARGUMENT.

I.

BY THE CORRECT CONSTRUCTION OF THE ACT THE COMPANY IS ENTITLED TO INCLUDE AS PAID IN OR EARNED SURPLUS AND UNDIVIDED PROFITS, UNDER SECTION 207 (A) (3) OF THE ACT, THE INCREASE IN THE VALUE OF THE ORE LANDS DUE TO THE DISCOVERY OF THE ORE BODIES AND TO THE NATURAL INCREASE IN THE MARKET PRICE OF ORE.

(1) The Act contains no definition of the words "paid in or earned surplus and undivided profits."

By Section 207 (a) (3) "invested capital" includes "paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year." But there is no statutory definition of this term.

It was not necessary to define this term, because the words when the statute was enacted had a definite, fixed meaning both in terms of accounting and law.

(2) Statutes imposing taxes are to be construed in favor of the taxpayer; the language employed is to be given its ordinary meaning; they are to be construed according to the spirit rather than the letter when the letter would make them palpably unjust; construed according to these rules the invested capital of La Belle Company should include all its outstanding stock where that is represented by property of an actual cash value not less than the par value of the outstanding stock.

It is established that all doubts in a revenue statute are to be resolved in favor of the taxpayer.

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. *In case of doubt they are construed most strongly against the government, and in favor of the citizen.*" Gould v. Gould, 245 U. S. 151, 153. (Italics ours.)

In Stratton's Independence v. Howbert, 231 U. S., 399, 414, the Court gave the following rule:

> "Of course, if it were demonstrable that to read the act according to its letter would render it unconstitutional, or glaringly unequal, or palpably unjust, a reasonable ground would exist for construing it according to its spirit rather than its letter."

As construed by the Department a heavy excess profits tax is levied on businesses whose income was not excessive, and on the other hand many incomes swollen by war escape the excess profits tax entirely, because *as construed by the Department* the law concerns itself with the original *cost* of property instead of its value.

In the case of La Belle Company the cost of the ore property in question was only $190,000. Its actual cash value in 1912 and at all times thereafter was more than $10,105,400. Since 1912 the actual stock outstanding against these ore properties has been $10,105,400. According to the construction put on the Act by the Department, a competitor which had in 1912 bought ore lands precisely similar in all respects at $10,105,400 (the value prevailing in that year) would be allowed to deduct the statutory 7 per cent to 9 per cent on $10,105,400 (the value in that year), that is from about $700,000 to about $900,000 and only the portion of income in excess of such deduction would be subject to tax, while the deduction of La Belle Company on account of *its* ore properties could be not more than 9 per cent of $190,000, or $17,100.

As a matter of fact, this company was allowed a deduction of 7 per cent (Rec., p. 4). This interpretation renders the law "palpably unjust." As applied to La Belle Company, the construction of the Department limiting the deduction to the *cost,* amounts to an additional tax of $1,081,184.45, making the total tax $6,202,294.45 out of an income for 1917 of $12,836,644.58, about 48 per cent of its total income, and a tax of one to two and a half on its capital stock; another corporation of like capital and income for 1917 with value as a basis instead of cost, would pay a tax of $5,139,109.64, about 40 per cent of its total income, and a tax of one to five on its capital stock.

Considering the law as applied to banking or investment corporations the injustice is perhaps more apparent. Two corporations might own exactly the same securities with an established market value of, say, $10,000,000, each receiving an income therefrom of $700,000, and yet one would pay no excess profits tax at all and the other would pay a severe tax on all income over $70,000. This would be the situation if one corporation had bought its securities for $1,000,000 while the second had paid $10,000,000; and yet the first corporation, under the Department's construction could, with no modification of its position, increase its invested capital to $10,000,000 by the simple process of selling its securities which cost $1,000,000 and are now worth $10,000,000 for the latter sum and then buying them back with the proceeds of the sale for the same price.

It is said that the Dutch bought Manhattan Island from the Indians for $24. If it had been purchased by a trading corporation (like the Hudson Bay Company) and that corporation still owned it, its invested capital represented by the island today would be $24, under the Department's construction.

These examples demonstrate that the Department's construction renders the law "glaringly unequal" and "palpably unjust."

(3) The ordinary meaning of the words "Paid in or Earned Surplus and Undivided Profits," includes appreciation in value.

We will postpone for the moment the question whether this increased value of the ore bodies is "earned"—there is no question that it is "surplus and undivided profits."

We contend that the only definition of "paid in or earned surplus and undivided profits" known to the law is that it is the excess of assets at any given time over all liabilities including capital stock; this definition necessarily including appreciation whether realized or unrealized. This is the definition given by the books. It is a simple definition capable of easy application.

The position taken by the Department which we assume will be supported by the Government in this Court is that nothing is "surplus" or "undi-

vided profits" which does not come from "income" and is not the result of "operations"—whatever that may mean—and that by this definition all appreciation is excluded until the property is sold and the profit thereby realized in cash.

If all the definitions in the books in support of our contention as above stated were printed in this brief it would be unduly expanded. We shall, therefore, refer only to a sufficient number to sustain beyond question the correctness of the definition above stated by us.

The following is from "Corporation Accounting," by R. J. Bennett (1917), Sec. 291, page 334.

> "*Surplus or Undivided Profits Account.* 'Surplus' account usually contains all those profits that are not reserved for some special purpose or which are not immediately to be distributed in the form of dividends. *Or, more broadly, it is the account in which is entered all excess of assets over liabilities which is available for dividends or other general purposes of the company. In the balance-sheet it is represented by the excess of assets over liabilities and capital,* the difference being a credit either to Surplus or to Undivided Profits, or sometimes to Profit and Loss." (Italics ours.)
>
> * * * * * * * * * *
>
> "Banks usually make a distinction between surplus and undivided profits. * * * Many corporations *make no distinction but*

use either one or the other for all purposes." (Italics ours.)

On page 336 of the same book is the following:

"Surplus is sometimes the result of a direct acquisition of value not belonging to the fiscal period or to the opening of business, *as an increase in value of real estate, of investments or of the assets of a permanent nature.* If such increase is permanent it may legitimately be credited to surplus account." (Italics ours.)

In "Accounting Practice and Procedure"(1917) by Arthur Lowes Dickinson (a member of Price, Waterhouse & Company, and an eminent accountant), page 62, is the following:

"The term 'surplus' which is in quite common use, is better confined to the *surplus of assets over liabilities* made up, as shown in the pro forma balance sheet, of appropriations for various purposes as well as of the balance of undistributed profit and loss." (Italics ours.)

The same author in an address delivered on September 27, 1904, before the Congress of Accountants, at St. Louis, on the subject of "The Profits of a Corporation" used this language:

"* * * *Definition of Profits:* In the widest possible view, Profits may be stated as

the realized increment in value of the whole amount invested in an undertaking; and conversely, Loss is the realized decrement in such value. In as much, however, as the ultimate realization of the original investment is from the nature of things deferred for a long period of years, during which partial realizations are continually taking place, it becomes necessary to fall back on *estimates of value at certain definite periods, and to consider as Profit or Loss the increase or decrease between any two such periods.* Hence, it follows that, as stated in Buckley's treatise on the English Companies' Acts, 'the ascertainment of Profit is in every case necessarily a matter of estimate and opinion. * * * The legitimate way is to take the facts as they actually stand and after forming an estimate of the assets as they actually exist' (and presumably, although it is not so stated, of the liabilities), 'show a balance so as to ascertain the result in the shape of Profit and Loss.' (Italics ours.)

"This definition would permit any business concern to revalue periodically the whole of its assets and liabilities and to record the difference between its surplus so ascertained at the commencement and the end of the year as its Profit and Loss, respectively; and provided that this estimate were fairly and reasonably made, there would be no objection to such a course. In other words, every appreciation

of assets is a Profit, and every depreciation a Loss; and in many private concerns this method, technically known as 'Single Entry,' of ascertaining Profits has been regularly adopted for years without bad results. A corporation, however, being endowed by statute with special privileges is subject to special restrictions, among others that of a definite fixed Capital Stock upon which dividends are declared out of the Profits of the undertaking. Hence, the consideration of Profits as applied to a corporation involves the consideration also of the limitations placed either by law or by sound principles of accounting upon their distribution as dividends. It is in the legal interpretation of the term Profits of a corporation (which has come to mean Profits available for dividends), and in the distinction between the strictly legal and conservative accounting view of the principles upon which they should be ascertained that the difficulties of the subject chiefly lie." (Italics ours.)

From "Modern Accounting," page 237, by Henry Rand Hatfield (1916) (professor of accounting at the University of California) we quote:

"• • • *Undivided profits* merely indicates, as the name suggests, a portion of the profits on which no specific action was taken. But the fact that it was not voted as a divi-

dend does *constitute it, in fact though not in name, a Surplus Reserve.* The reason for differentiating is the unwillingness to distribute so closely the profits as to run the risk of having a Debit balance appear in the Profit and Loss account." (Italics ours.)

In "The Science of Accounts," by Harry C. Bentley (1913), page 24, Sec. 36, is the following definition:

> "*Surplus:* The excess of assets over liabilities and capital is called surplus." * * *

From "Financial and Business Statements," by Leo Greendlinger (Alexander Hamilton Institute, 1917), Vol. 22, page 195, we quote:

> "*Definition of Surplus:* By the term surplus is meant the intrinsic value of all the assets of a firm over and above its liabilities and outstanding capital."

From page 196:

> "*Sources of Surplus:* Broadly speaking, surplus may be derived from the following sources:
>
> (1) From profits as a result of business operation;
> (2) *From a revaluation of fixed assets;*
> (3) From an original investment at the time of organization or as a result of reorganization.

The American Association of Public Accountants publish annually a "Year Book", which contains among other things accepted definitions of accounting terms.

From the Year Book for 1911, page 124, we quote:

> "*Surplus:* (a) In the restricted sense it means accumulated undivided profits.
>
> (b) When used in the *ordinary* sense in a financial statement, *it means excess of assets over liabilities and capital. In this sense surplus may include gains arising from acquisition of assets not derived from the ordinary operation of the business.* If the excess of assets equals the capital there is no surplus, the capital just balancing the excess or net worth of the business." (Italics ours.)

The foregoing are all from authoritites on accounting. It is possible that the Government may be able to find isolated expressions by accountants which taken by themselves may seem to lend color to the argument that increase in value is not a part of surplus until the property is turned into cash. But it is believed that a closer examination of any such statements will disclose that they amount to no more than that in the author's opinion it is not a conservative practice to treat as an asset, appreciation that has not been realized by a sale of the property. Of course we have no quarrel with any such opinion.

We find that text text writers on law and decided cases give the same definition of surplus and undivided profits as the accountants.

The subject is carefully considered by Mr. Machen, one of the best modern writers on law. We quote from his work, "Modern Law of Corporations", Vol. II, pp. 1092, 1095:

> 1314. "Availability of Excess of assets over Liabilities and nominal Capital for Dividends. —*Any excess in the value of a company's assets over its liabilities and paid-up nominal or share capital, whether due to earnings or to an appreciation of property, may, it seems be treated as profits available for dividends.* * * *" (Italics ours.)
>
> 1320. "*In General. We have seen that no separate revenue account is a necessary preliminary to the declaration of dividends, but that a complete valuation may be made at any given time of all the company's assets—capital and accrued earnings—the excess of which over the liabilities and nominal, paid-up capital is distributable as dividends.*" (Italics ours.)

Another writer on corporation law whose opinions have justly been accorded great consideration is Mr. Morawetz. We quote passages from his book "Private Corporations", 2d Ed., Vol. I, p. 412:

> "438. *Method of Ascertaining Profits.* The right to declare a dividend depends upon the state of the company's finances at the time when the dividend is declared. *The question usually is, whether or not there would remain a net increase upon the original investment, after deducting from the assets of the company, all present debts and making provision for future or contingent claims.* It is immaterial at what time the increase was earned. Profits accumulated by a corporation in times of prosperity may be distributed by the company subsequently when no profits are earned." (Italics ours.)

See also Thompson on Corporations, Section 5307, 2d Edition. Cook on Corporation, 7th Edition, Volume II, Section 536.

In Park vs. Grant Locomotive Works, 40 N. J. Eq. 114, profits are defined as follows:

> "The clear gain of any business venture, after deducting the capital invested in the business, the expenses incurred in its conduct, and the losses sustained in its prosecution." (121)

The foregoing authorities are all, of course, directly contrary to the Government's position. But apart from authority no other definition of surplus than the one given in this brief will stand analysis. The Department's definition excluding

appreciation from surplus when analyzed closely shows itself to be unsound; for it is admitted that when the property is sold the profit may became a part of surplus. But the sale does not *create* the profit.

The value of a corporation's property was specifically held to create a surplus by the Court of Appeals of the State of New York, in the case of Williams vs. Western Union Telegraph Company, 93 N. Y. 162. The main contention in the case was, that the stock dividend distributing upwards of $15,000,000 of stock among the stockholders of the Western Union Telegraph Company was unauthorized and in violation of law. The Court said:

> "The stock dividend was claimed to be in violation of Chapter 18, part 1, title 4, section 2, of the Revised Statutes which provides as follows: 'It shall not be lawful for the directors or managers of any incorporated company in this State to make *dividends excepting from the surplus profits arising from the business of such corporation.*" (186)
>
> "* * * It is conceded that the directors of the Western Union Telegraph Company could have issued this stock for money to be paid into its treasury. It could have issued it for property to be received by it for the purposes of its legitimate business. But here it is found that over and above its capital it possessed property actually worth upward of $15,000,000, and we know of no law that is vio-

lated, and no public policy that is invaded by issuing to the stockholders stock to represent that amount of property rather than in any mode to divide it up and distribute it among them. If it can issue stock in payment of property to be obtained by it as a part of its capital for its legitimate uses, why may it not issue stock to its stockholders in payment for property in effect purchased of them and added to its permanent capital, and which they relinquish the right to have divided? (190)

"The company had made surplus earnings which it could have divided, but instead of dividing them it had invested them in property to facilitate and enlarge its business; and such property was found to be worth $15,526,590. That sum constituted its surplus." (191) (Italics ours.)

In *People* v. *Tax etc. Com'rs*, 76 N. Y. 64, 74, it was said:

"Surplus earnings is an amount owned by the company over and above the capital and actual liabilities * * *"

In *People ex rel.* v. *Barker*, 165 N. Y. 305, surplus profits were thus defined:

"As we understand this statute, the *surplus profits* or reserved funds mean the *accumulations* of the company of moneys or property in excess of the par value of the stock issued by it." (Italics ours.)

In McGinnis vs. O'Connor, 72 Atl. (Md.) 614, the original stock issue was $15,000. The plant, good will, etc., were revalued at $25,000 and new stock issued for the additional $10,000. This was held by the court to be valid. We quote from this case:

> "As to the profits it seems to have been agreed among all the parties in interest that the plant, good will, and whisky on hand was worth at least $25,000 at the end of four years, and this being $10,000 more than the whole original capital stock of corporation No. 1, might well be treated as profits, as also the 32 shares not delivered to Dougherty."

Mangham vs. State, 75 S. E. (Ga.) 508, was a criminal case for unlawfully declaring a dividend. The court found it necessary to determine whether or not the corporation has a surplus from which a dividend could be declared. Surplus was defined as follows:

> "* * * 'The surplus over and above the capital and debts constitutes profits.' Barry v. Merchants Exchange, 1 Sandf. Ch. (N. Y.) 280, 307. And the Supreme Court of the United States said that the term 'profits' out of which dividends alone can be declared, denotes what remains after defraying every expense, including loans falling due, as well as interest on such loans. Eyster v. Continental Board, 94 U. S. 500, 24 L. Ed. 188." (510.)

Hutchinson v. Curtiss, 92 N. Y. Sup. 70, was an action by common stockholders against a director to account for dividends alleged to have been paid in violation of a statute which provided that dividends should not be paid "except from the surplus profits arising from the business of such corporation." It appeared that the increase in bulk by the conversion of barley into malt had been valued at the same price per bushel as the original barley, although evidently this was including appreciation in surplus.

The Court said:

> "The process of manufacture produces about 15 per cent more of malt by the bushel than the barley measures from which it is produced. * * * *But it certainly is an asset of the company, and as an asset at inventory periods, or when it is necessary to ascertain the actual condition of the company, it must be valued in some way.*" (74)

"Undivided profits" are part of the assets and really part of the broader word "surplus." This was recognized in *Simcoke* v. *Sayre*, 148 Ia. 132, where it was said:

> "The term 'profit' has a larger meaning than 'dividends', and covers benefits of any kind, *excess of value over cost*, acquisition beyond expenditures, *gain or advance.*" (Italics ours.)

In *Anderson* v. *Farmers etc. Co.*, 241 Fed. 322, 326, the same idea was thus expressed:

> "* * * the words 'capital, surplus and undivided profits' relate to no particular kind of property, but are *expressions describing the amount or residue of the assets after the liabilities have been deducted.*" (Italics ours.)

See also Roberts v. Roberts-Wicks Co., 184 N. Y. 257. Hubbard v. Weare, 79 Iowa 678. Miller v Bradish, 69 Iowa 278. Equitable Life Assurance Society v. Union Pacific R. Co., 212 N. Y. 360.

From the foregoing cases it appears conclusively that appreciation in value is consistently treated in the books as surplus.

(4) The word "earned" does not limit the surplus which is to be included in invested capital. The statute merely contrasts "earned" with "paid in" surplus.

The Department takes the position that the word "earned" in the phrase "paid in or earned surplus and undivided profits" is a word of limitation; that, while within the definition of the books this appreciation might be "surplus," Congress did not mean to include *all* surplus but only such surplus as was "paid in" or "earned," and that appreciation not realized by the sale or exchange of property, although "surplus," is not "earned surplus." The Government contends that the word "earned" used in connection with "surplus" limits the appreciation which can be included in

surplus to "realized appreciation." In this way they consider that the word "earned" is used as synonymous with the word "realized."

We take just the contrary view. The phrase in the act is "paid in or earned surplus and undivided profits." The meaning of *"earned"* is not the same as *"realized."* It includes in meaning "to acquire the benefit of although not realized." As we commonly say, "A is *earning* his pay this week." We speak of a man as *earning* a promotion prior to his achieving it, or *earning* an office prior to attaining it. Therefore, this word is peculiarly fit to single out and indicate a recognized benefit which has been "acquired" and which adheres in property which has not yet been realized upon in cash.

We quote from the Standard Dictionary:

> *"Earn:* * * * (1) To gain as a just return or recompense by service, labor or exertion; as, He *earned* six dollars a day. (2) To merit by reason of service or exertion; as, He has *earned* the nomination and should have it. Synonyms: See—Acquire, attain, gain, get."

In Stevens v. U. S. Steel Corporation, 68 N. J. Eq. 373, which was a suit to compel the distribution of a dividend, there was involved the interpretation of the term "accumulated profits" used in the statute. The Court said of this phrase:

> "Possibly not a tenth of that amount existed as cash—as profits *not only earned, but actually received.* * * * Earned accumulated profits may be a very different thing for the purposes of distribution from accumulated profits. Earnings may be made without ever being received." (380)

The Court here contrasts the words "earned" and "received."

In Lewis' Estate, 156 Pa. 337, a statute which provided that "property of every kind owned, acquired, or *earned* by a woman before or during her marriage shall belong to her and not to her husband," was held to give to the wife the right to sue in her own name for services rendered by her during her marriage, on the theory that, although *not realized* by her, the money due had been *"earned"* by her.

Nuding v. Urich, 169 Pa. 289, held that in a later statute giving a married woman the right to "acquire, own, possess," etc., the word *"acquire"* includes everything that would be included in the word *"earned"* in the statute considered in the first case above mentioned.

Our contention on this subject is that if the appreciation is surplus at all it is necessarily "paid in or earned" surplus. The word "earned" was probably used in contrast to "paid in" in the clause "paid in or earned surplus and undivided profits," and was perhaps intended to emphasize the thought that the surplus must be real and not fictitious. We

contend that there are only two kinds of surplus, "earned" and "paid in," and that there is no third kind known to the law and that if an item is surplus at all it must necessarily be one or the other.

Too much emphasis has been placed upon the ascertainment of a profit by a sale. The Government admits that profit realized on a sale may be included in surplus. But if it be admitted that appreciation *after* realization is *earned* surplus, then it must be admitted that appreciation is *earned* surplus *before* the property is sold. The sale does not create the earning; it is the gradual increase in value which is the earning.

It is hard to see how the mere act of selling could be considered to constitute the "earning" of the profit that would accrue to the company out of the long continued ownership of these ore properties. This is to place a wholly unreal emphasis upon the importance of the sales department as compared with other departments of a business.

But if the word "earned" has any such narrow meaning as is contended for, that narrow meaning is not applicable to La Belle Company in view of the facts admitted by the demurrer. The petition alleges that after the acquisition of the ore properties, extensive explorations and development work was carried on, and that by 1912, and at all times thereafter to 1917, the actual cash value of the ore lands was not less than $10,105,400. (Rec., p. 4.)

At all events, the words "earned surplus" do not have any such unequivocal meaning as to require the Court to so interpret them as to do violence to

the principles of natural equity and justice. All that the Company need establish in this Court is that there is a doubt as to the meaning of these words. If there be a doubt it must be decided in favor of the taxpayer.

(5) New Capital Stock of the Company was issued because the value of the ores justified it and this was a realization of the increased values.

The demurrer admits that the ore lands had an actual cash value from 1912 to 1917 of $10,105,400, or $9,915,400 more than the $190,000 paid for them prior to 1904. It is the contention of the Government, however, that since this increased value was not "realized" by the *sale* of the ore lands by the company it can not be included in invested capital. There is nothing in the statute about "realization" or ascertainment of the value of appreciation by sale. It is simply convenient for the Government to require a sale or exchange to determine appreciation, and that theory has been adopted.

But the issue of new stock based on the appreciation in value was in fact just as much of a realization as a sale. When the stock dividend was declared that which was before surplus became *permanent capital*. A fund *available* for dividends had been converted into a fund *not available* for dividends. The declaration of the stock dividend not only was a distribution of earnings, but it destroyed all possibility of any other future dividend

distribution therefrom. After that the dividends would have to be of the nature of earnings on the then capital. By the declaration of the stock dividend, the rights of the stockholders in this surplus became diminished, and the rights of the corporation became increased. The surplus became capital—its control by the corporation became thereby perpetuated.

The act in question does not require the ascertainment of the value of appreciation to be solely by sale or exchange (that again is a requirement of the Treasury Department regulations). Such fact may be determined in other ways than by sale or exchange. Here we have the more solemn fact of a capitalization and issue of stock against the amount so capitalized, all occurring in 1912.

(6) This court in construing the 1909 corporation excise tax law, and the 1913 income tax law held that appreciation accruing before the incidence of the tax was capital. The word "capital" as used in these cases must include "surplus."

The word capital is sometimes used as meaning the net worth of a corporation thus covering not only the original capital but also surplus and undivided profits. The ruling of the Department is that until the property has been sold or exchanged at a profit there is no surplus. If appreciation is not surplus prior to realization it would not be a

part of the "capital" of the corporation using that term in its large sense.

But there is a line of cases decided by this Court which seem to be conclusive against that contention. In several cases this Court has recently decided that increase of value which accrued prior to the institution of a tax on income is a *part of the capital of the corporation* and can not be taxed as income when the property is subsequently sold.

In Hays v. Gauley Mountain Coal Co., 247 U. S. 189, the Court held that, under the 1909 corporation tax law, so much of the appreciation as had accrued prior to January 1, 1909, was capital.

Doyle v. Mitchell Bros. Co., 247 U. S. 179, was a case brought to recover taxes paid under the Act of 1909. The plaintiff bought timber land in 1903 at approximately $20 per acre. On December 31, 1908, the market value had become approximately $40 per acre. The company made *no entry on its books* representing this increase, but in its return for the years 1909-10-11-12 deducted from its gross receipts for sale of the lumber the market value as of December 31, 1908, of the stumpage cut and converted during the year covered by the tax. The Commissioner having allowed a deduction of the cost of timber in 1903, and having refused to allow the difference between that cost and the fair market value on December 31, 1909, the question was whether the difference (made the basis of the additional taxes) was income for the years in which it was converted into money, within the meaning of

the act. A final judgment was given for the plaintiff, the Court saying:

> "*When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets,* and a subsequent change of form by conversion into money did not change the essence." (187)

In Southern Pacific Co. v. Lowe, Collector, 247 U. S. 330, in considering the 1913 income tax law, the Court used the following language:

> "* * * We are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the act. *And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer.* * * * (335) (Italics ours)

To the same effect are Towne v. Eisner, 245 U. S. 418; Lynch v. Turrish, 247 U. S. 221; Lynch v. Hornby, 247 U. S. 339.

In the above cases this Court has held that increment in value accruing to a corporation is capital even before realization by sale and is not subject to be taxed as income when the property is sold in a subsequent year.

Let us consider for a moment the implications of this doctrine. Unrealized appreciation in value

is thus held to be "capital." The Court, of course, was not considering whether it was "invested capital" or whether it was to be treated as "surplus." But does it not necessarily follow that this unrealized appreciation which the Court calls "capital" must be denominated surplus in most cases? If the capital stock of a corporation represents the original cost and if the appreciation in value over that sum is "capital," how can it be "capital" unless it is "surplus"? Strictly the "capital" is represented by the stock of the corporation. All assets over and above all liabilities (including capital stock) must be "surplus."

(7) The Government's argument that the provisions of clause (2) of the Act permitting appreciation in certain cases excludes it in clause (3) only proves that the Act is in parts inconsistent.

If the Government finds in the Act any wording which may be claimed to indicate an intention to exclude appreciation, the words "surplus and undivided profits" just as certainly include appreciation. It is notorious that the Act was prepared in great haste. The first impression was that it was so defective as to be unworkable. Under the Government's theory, we have a case of contradictory expressions in the same Act. The task is imposed on the Court, therefore, of adopting a construction of the statute. The Government's contention does violence to the universally accepted

meaning of the words "surplus and undivided profits" and makes the Act palpably unjust and we believe unconstitutional. There is another construction which at least is just as consistent with the words of the Act as the Government's and which would make the tax operate justly on all taxpayers. Between these choices surely the interpretation favoring the taxpayer should be adopted.

(8) The construction here contended for will impose no heavier burden on the Department than the construction of the Government.

The objection made below that to include appreciation in invested capital will cause a great deal of work by the Department is, on examination, found to be no objection at all. For all property of corporations except perhaps real estate (and even that under certain circumstances) is under the Department's construction of the Act already valued under the Act as of some day or other.

(a) The Act, Clause (2) *supra* requires that all property paid in for stock shall be valued as of the date of its acquisition, or as of January 1, 1914. To determine its value at such a remote date is a far greater burden than to determine its present value.

(b) All merchandise, raw material, work in process, finished product, bonds, stock and other

items appearing in inventories are necessarily valued at the end of each fiscal period.

(c) All buildings, plant, equipment and machinery, etc., are today valued as of March 1, 1913, for the purpose of fixing a valuation to be used for the purpose of determining the depreciation allowance to be deducted in determining net income; all ore bodies are likewise valued as of March 1, 1913, for the purpose of determining depletion allowance.

It therefore appears that, including real estate, all property paid in for stock must be valued under the Act at some date or other; and except real estate, all property of corporations, no matter how acquired, must be valued for one purpose or another under the Act.

Further, the Government today must annually arrive at a rough valuation of all corporate property for the purpose of assessing the capital stock tax, which is a tax quite separate and distinct from the income and excess profits tax. (Title X, Revenue Act of 1918.)

In addition, practically all the property in the country, real and personal, is today valued once a year for state taxation purpose.

The contention, therefore, that the construction here contended for would impose a new and alarming burden on the Department need not disturb the Court.

II.

THE STOCK OF THE COMPANY CONSISTING OF COMMON STOCK, PAR VALUE $9,915,400, AND PREFERRED STOCK, PAR VALUE $9,915,400, A TOTAL OF $19,830,800 ISSUED IN 1912, WAS FULLY PAID FOR EITHER BY (1) THE TANGIBLE ASSETS INCLUDING THE ORE LANDS AT THEIR INCREASED VALUE, OR (2) THE CERTIFICATES OF THE OLD COMMON STOCK. IN EITHER CASE TANGIBLE PROPERTY WAS PAID IN FOR SHARES WITH AN ACTUAL CASH VALUE WITHIN SECTION 207 (A), (2) EQUAL TO $19,830,800—AND THE COMPANY IS ACCORDINGLY ENTITLED TO INCLUDE THE FULL AMOUNT IN ITS INVESTED CAPITAL.

In 1912 La Belle Company had outstanding capital stock having a par value of $9,915,400. In that year the net assets of the company had a value of more than $9,915,400 in excess of that par value. This outstanding stock was in that year surrendered by the stockholders to the company and in exchange therefor one share of the new common and one share of the new preferred stock was issued in place of each share of the original stock outstanding. After this transaction the stockholders instead of holding only $9,915,400 par value stock, held in the aggregate $19,830,800, of which $9,915,400 was common stock and $9,915,400 preferred stock. Either the new common stock or the new preferred stock was issued against the increase in valuation of the ore lands. The Department reduced the invested capital of the Company by $9,915,400, thus disallowing either the whole of

the new common stock or the whole of the new preferred stock. It is not clear which, and it does not matter which the Commissioner has disallowed. He has disallowed whichever was issued as representing the increased valuation. But the claimant will show that every share up to the combined par value of $19,830,800, and therefore both the common stock of $9,915,400 and the preferred stock of $9,915,400, was fully paid for by tangible property with an actual cash value up to that amount, and therefore should be included in the Company's invested capital.

The Revenue Act of 1917, Sec. 207 (a) (2), provides that invested capital shall include the actual cash value of tangible property paid in for shares at the time it was paid in, or the actual cash value on January 1, 1914; in no case to exceed the par value of the stock issued therefor. The exact words of the statute are:

> "(a) * * * (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), * * *"

This clause was plainly intended by Congress to provide for just such a case as that of La Belle Company. By that clause it was intended to include in invested capital all outstanding stock where that did not exceed the fair cash value on January 1, 1914, of the property against which it was issued. The stock in question was issued in 1912. It must be conceded that by general corporation law the stock when issued was fully paid for. What we mean is that if an attempt had been made to enforce a stockholder's liability against the holders of these shares, the courts would have hel l the shares to have been fully paid for. (See Cook on Corporations, 7th Ed., Vol. II, Sec. 536.) Since, therefore, this additional stock was fully paid for, it must have been paid for with something. It was not paid for by cash. Necessarily, therefore, since it was fully paid for with something, it was paid for with property.

What then was the property which paid for the additional stock issued in 1912?

(1) Were not the ore properties at their increased value the "property paid in" for the additional shares issued in 1912?

That is the property today back of these shares. The statute does not require that property shall be paid in *at the time* of the issuance of the shares. Clearly, the purpose was to allow as invested capital the par value of shares outstanding on January

1, 1914, issued against property, provided the actual cash value of the property was on that date equal to the shares. To say that it must be limited to cases where there was a contemporaneous exchange is to make a difference in tax depend upon an accidental and trivial circumstance.

The statute should *not* be construed as though it had said that "the invested capital shall include the stock or the shares delivered to the owner of the property in payment of the property by him conveyed to the corporation." The expression can properly be construed in a sense much broader than that. All that is required is that tangible property shall have been paid in to the corporation and that it shall be "for stock or shares in the corporation." Surely to accomplish the real purpose of these words, invested capital should be construed to include the actual cash value on January 1, 1914, of the tangible property paid in or delivered to the corporation which represents stock or shares in such corporation not to exceed the par value of the stock.

As was said in Williams vs. Western Union Telegraph Company, 93 N. Y. 162, 190:

> * * * "But here it is found that over and above its capital it possessed property actually worth upward of $15,000,000. * * * If it can issue stock in payment of property to be obtained by it as a part of its capital for its legitimate uses, why may it not issue stock to its stockholders in payment for property *in*

effect purchased of them and added to its permanent capital, and which they relinquish the right to have divided? * * *"

In its essence the transaction in 1912 amounted to this: The shareholders surrendered all their old shares and thereupon, being in effect the owners of all the assets, "paid in" those assets to the corporation in exchange for the new stock issue.

(2) If these additional shares were not paid for by the ore lands, all the shares issued in 1912 were paid for by the surrender of the old shares, which were tangible property with an actual cash value of twice their par value.

If the Government contends that these shares were not paid for by the ore lands, by what property were they paid for? They must have been paid for by some property. It is plain in that case that they were paid for by the delivery to the Company of the certificates representing the old shares by their then owners. In 1912 the Company had outstanding stock of a par value of $9,915,400 all of one class. But this capitalization represented the ore lands at a valuation of only $190,000 which lands in fact were worth $9,915,400 more than that. The old shares, therefore, had a value at least twice their par value of $9,915,400.

Article 47, of Regulations 41, relative to the War Excess Profits Tax imposed by the Revenue Act of

1917, promulgated by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury, provides:

> "The following classes of property, when paid in for stock or shares in a corporation or partnership, will be regarded as tangible property so paid in;
>
> (a) Stocks.
>
> * * * * *"

It must then be conceded that the old shares were tangible property.

Every old shareholder "paid for" two shares of new stock (one share new preferred and one share new common) by delivering a certificate for one share of the old stock. Therefore, literally, within the precise wording of the Act, "tangible property" (the certificates for the old shares) was "paid in for stock or shares" (new shares) in the Company. The Company, therefore, literally, comes within the precise wording of clause 2 (a) of Section 207 of the Act. The invested capital includes the fair cash value of the old shares.

No holder of the old common stock of the Company could have been compelled to exchange one share of the old stock for one share of new preferred and one share of new common, and if there had been objecting stockholders the Company in order to carry through the plan would have been compelled to buy the old shares not owned by those objecting stockholders. Instead of doing that it

acquired the old shares by the issuance for each old share of one share of new common and one share of new preferred. These old common shares therefore were paid in to the corporation for the new shares just as literally as any other tangible property might have been paid in.

Will it then be said that this construction is too narrow? There are many answers to that. Among them is that the taxpayer has a right to insist upon the narrow wording of the statute. He has a right to demand that he shall not be taxed except in accordance with the explicit words of the statute.

If it is said that this gives a capricious advantage to this particular Company owing to the peculiar facts, we can answer that *capriciousness is the very essence of the excess profits tax as interpreted by the Department.* The Company was not taxed on any principle of equity but because the Department believed the literal reading of the law required it. In any one of the following cases, substantially that of La Belle Company but differing slightly in form, it will be conceded that the $9,915,400 appreciation in the value of the ore lands would be included in invested capital:

(1) If the seller of the ore lands had in 1902, instead of cash received in payment preferred stock to the amount of the actual cash value at that time, to wit, $190,000, and in addition watered stock to the amount of $9,915,400, and if by January 1, 1914, there had been an appreciation of $9,915,400,

this appreciation could be included in invested capital. This is explicitly provided for by the proviso to Clause (2) of Section 207 above quoted. But it is claimed that because La Belle Company did not issue this additional stock until 1912 when the appreciation had been demonstrated, the appreciation can not be included. In other words, the reckless financier is to be rewarded.

(2) If the Company had sold the ore lands for their value, $10,105,400, of course the appreciation $9,915,400 could be included. It is admitted that in that case appreciation becomes "earned surplus." But it is evident that the mere sale does not *create* the surplus. The profit has been accruing over a long period of years. Conversion into cash does not create the profit, and in fact, as will be shown in the next instance, a conversion into cash is not necessary.

(3) If the lands had been exchanged for other ore lands precisely similar which had a market value of $10,105,400, then the Government will concede this would have been a realization of the profit in the original ore lands, and the invested capital on account of the substituted ore lands would be $10,105,400, and include the appreciation of $9,915,400. This again is a distinction without substantial difference.

(4) If the Company had distributed these lands to its shareholders ton by ton in the year 1912, and

the shareholders had then reconveyed these ore lands to the Company in payment for $10,105,400 of stock, this again would have constituted a payment in of these lands in exchange for shares, and therefore the Company could have claimed that amount of invested capital. Surely a shadowy distinction!

(5) Had the Company in 1912 borrowed $9,915,400, issuing bills payable therefor, and distributed this as a cash dividend, and thereafter had sold a new issue of its stock for $9,915,400 in cash and, with this cash, retired its bills payable, this cash paid for the new stock would be part of its "invested capital."

(6) If in 1912 the Company had sold the ore lands for $10,105,400, and later had bought the lands back with the same money, the invested capital by that operation would have been increased by $9,915,400.

(7) If there had been a reorganization involving the formation of a new company to which all the assets had been transferred, the stock being held in the same proportions by the same people, such new corporation could have claimed an invested capital of $10,105,400 on account of the ore lands. The Company came very close to doing that very thing. All the old stock was called in, the charter was amended to provide for two classes of stock, and

each holder of one old share received one share of new preferred and one share of new common. To draw a distinction between what was done in our case and the formation of a new company holding precisely the same assets, with precisely the same number of shares held by the same persons in the same proportions, is to make the tax utterly freakish and capricious, and to make it depend on accidental and trivial circumstances.

In all of these cases, substantially similar to our own, it will be conceded that the increased value of the ore lands would be included in invested capital. The transactions in question were long before the war or the excess profits law was contemplated, and obviously were not done in contemplation thereof. The Government attempts to apply its artificial construction to the disadvantage of La Belle Company, and claims it is applying the letter of the law, and that an additional tax must be imposed, however inequitable. A slight change in its organization would have enabled the Company to escape the tax, which emphasizes the fact that the Department's imposition of the tax depends upon form only. If this claimed letter of the law is to be applied up to the point of imposing an additional tax, then the *whole* letter of the law must be applied no matter how unusual the facts are and how fortunate the Company may be in including the ore lands at their actual value of $10,105,400 by applying the whole letter of the law.

To summarize: In our judgment it is most inequitable to make the right to include increase in value in invested capital turn on so accidental an element as the mere form which the organization of the Company took; but if the Government insists that the tax was meant to be just as accidental and capricious as that, then we may say La Belle Company is entitled to the accidental advantage that it can get from the statute, and under the literal terms of the statute it should pay no additional tax. For it issued $19,830,800 of stock in 1912 which was fully paid for by tangible property, either the original lands or the certificates of the old common stock paid in to the corporation, strictly in accordance with clause (2) supra.

III.

THE CONSTRUCTION PLACED UPON THE ACT BY THE DEPARTMENT WOULD CREATE A WHOLLY BASELESS AND ARBITRARY DISCRIMINATION AMOUNTING TO A DEPRIVATION OF PROPERTY WITHOUT DUE PROCESS OF LAW. SUCH A CONSTRUCTION IS TO BE AVOIDED IF THE ACT IS TO BE CONSTITUTIONAL.

On the constitutional point it is our contention that the construction placed upon the law by the Department puts it in the same class with the hypothetical statute suggested in Davidson v. New Orleans, 6 Otto 97:

> " * * * a statute which declared in terms, and without more, that the full and exclusive title of a described piece of land, which is now in A, shall be and is hereby vested in B, would, if effectual, deprive A of his property without due process of law, within the meaning of the constitutional provision." (619).

We shall *not* raise any point in this argument on the provisions of the Constitution which require uniformity and apportionment in the levying of certain taxes; although as to the clause requiring apportionment the question is by no means free from doubt. As to that clause a strong argument might be made that this tax is not an income tax within the Sixteenth Amendment, and if it is not an income tax it is invalid because not apportioned. It is a question of considerable doubt whether this tax is not really a tax on property and capital, and not on income, since the amount of tax depends not so much upon income as it does upon the cost of the taxpayer's assets. When that cost is sufficiently large then a very large income will escape the tax. Where the cost is low, a corporation with exactly the same assets and the same income will pay a heavy tax. These considerations tend to throw serious doubt upon the constitutionality of the excess profits tax as a whole. However, we do *not* propose to argue that question. For the purposes of this argument we shall assume that the tax is a super-income tax and shall discuss its constitutionality on that basis.

(1) This Court has said that if there was arbitrary confiscation in a taxing law of Congress there would be a want of due process.

We shall not discuss the question raised in certain cases such as Knowlton v. Moore, 178 U. S., 41, and McCray v. United States, 195 U. S., 27, whether, apart from express constitutional provisions, a law might be so confiscatory as to be contrary to the fundamental conceptions of all free governments and therefore void. We shall confine our argument to the contention that a wholly arbitrary exaction although in the guise of a taxing law is contrary to the Fifth Amendment.

On that subject the law seem to us to be perfectly plain. One may encounter in the books chance statements that the Fifth Amendment does not qualify the taxing power. If what is meant is that a taking of property by way of tax is not *per se* obnoxious to the Fifth Amendment, it is, of course, true. But if by the statement it is meant that Congress may, unfettered by the Fifth Amendment, resort to arbitrary and ruthless discriminatory confiscation of private property so long as it is called a tax, then we say emphatically that this is contrary to principles thoroughly established by repeated decisions of this Court.

The taxing power is just as much subject to the bill of rights as any of the other powers conferred upon Congress. Just as the power to regulate interstate commerce is subject to the Fifth Amendment (New York Central and Hudson River Rail-

road Company v. United States, 212 U. S., 481; United States v. Adair, 152 Fed. Rep., 737); just as the regulation of the Indian tribes is subject to the Fifth Amendment (Choate v. Trapp, 224 U. S., 665); so the power of Congress to tax is likewise subject to the Fifth Amendment.

If, therefore, a statute in a wholly arbitrary manner by a baseless and arbitrary classification, confiscates the property of one person and leaves exempt another person in precisely the same situation, such a law, although called an exercise of the taxing power, must be held to be merely confiscation of private property and therefore contrary to the Fifth Amendment.

And, of course, this doctrine is not limited to invalidating Acts of Congress which avowedly aim at confiscation. It must especially apply to statutes which plausibly claim to accomplish only a reasonable classification. For presumably no act passed by Congress would *purport* to be an act of confiscation. It would always *purport* to be a legitimate exercise of some power delegated to Congress. In every such case the question for the Court always is whether the legislation in question is in truth the legitimate exercise of a delegated power, or is merely cloaked as the exercise of a legitimate power. If in effect it is not the former but is an arbitrary deprivation of life, liberty or property, it comes within the meaning and prohibition of the Fifth Amendment.

It is settled that the due process clause is not sat-

isfied merely by a direction that the procedure shall be regular. Confiscation although performed in the most regular fashion would still be wanting in due process. No one can formulate a rule which will define in advance what will amount to confiscation. Each case must be examined by itself. As Mr. Justice Holmes said in Martin v. District of Columbia, 205 U. S., 135—"constitutional rights like others are matters of degree." (139)

It is settled that the clause is not merely a limitation on administrative officers—it is a limitation upon Congress; otherwise Congress could by merely declaring its process—"due process"—confiscate the property of any individual. See Den v. The Hoboken Land and Improvement Co., 18 How., 372.

We shall refer to certain cases in which taxing acts passed by Congress were claimed to be invalid. In none of these cases was the tax held by the Court to be invalid. *But all of them assume that if the tax amounted to a wholly arbitrary exaction, the law would be invalid.*

In Knowlton v. Moore, 178 U. S., 41, in which was considered the constitutionality of the War Revenue Act of 1898, the Court found that none of the provisions of the act rightly construed amounted to such an arbitrary classification as to bring up the question of their constitutionality But the Court plainly intimated that there might be a case of such arbitrary classification as to make the tax void. The Court used the following language:

"It may be doubted by some, aside from express constitutional restrictions, whether the taxation by Congress of the property of one person, accompanied with an arbitrary provision that the rate of tax shall be fixed with reference to the sum of the property of another, thus bringing about the profound inequality which we have noticed, would not transcend the limitations arising from those fundamental conceptions of free government which underlie all constitutional systems. On this question, however, in any of its aspects, we do not even intimate an opinion. * * *" (77.)

At this point we may note that the amount of the excess tax in the present case is made to depend not so much upon the size of the income, or the fair value of the taxpayer's assets, as *upon the cost of those assets.* Is not this as great "an irregularity" as would be produced if the tax were made dependent upon "the sum of the property of another"—the illustration suggested in the above language?

Further on in the same opinion the Court used the following language:

" * * * If a case should ever arise, where an arbitrary and confiscatory exaction is imposed bearing the guise of a progressive or any other form of tax, it will be time enough to consider whether the judicial power can afford

> a remedy by applying inherent and fundamental principles for the protection of the individual, even though there be no express authority in the Constitution to do so. That the law which we have construed affords no ground for the contention that the tax imposed is arbitrary and confiscatory is obvious." (110.)

In Brushaber v. Union Pacific Railroad Company, 240 U. S., 1, this Court discussed the constitutionality of the income tax provisions of the Act of October 3, 1913. It was urged that inequalities in the Act made the tax void as a violation of the Fifth Amendment. The important point for us is not the facts in that case but the admission by the Court that a tax would be void under the Fifth Amendment if "so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property; that is, a taking of the same in violation of the Fifth Amendment." The Court held, however, that in that case none of the inequalities relied upon presented that question in the case. We quote from the opinion:

> "So far as the due process clause of the 5th Amendment is relied upon, it suffices to say that there is no basis for such reliance, since it is equally well settled that such clause is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, that the Constitution does not conflict

with itself by conferring, upon the one hand, a taxing power, and taking the same power away, on the other, by the limitations of the due process clause (Citing cases * * *). *And no change in the situation here would arise even if it be conceded, as we think it must be, that this doctrine would have no application in a case where, although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a confiscation of property; that is, a taking of the same in violation of the 5th Amendment; or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.* We say this because none of the propositions relied upon in the remotest degree present such questions. It is true that it is elaborately insisted that although there be no express constitutional provision prohibiting it, the progressive feature of the tax causes it to transcend the conception of all taxation and to be a mere arbitrary abuse of power which must be treated as wanting in due process. But the proposition disregards the fact that in the very early history of the Government a progressive tax was imposed by Congress, and that such authority was exerted in some, if not all, of the various income taxes exacted prior to 1894 to which we have previously adverted." (24, 25.) (Italics ours.)

See also: Wagner v. Leser, 239 U. S., 207; Twining v. New Jersey, 211 U. S., 78; McCray v. United States, 195 U. S., 27; Flint v. Stone Tracy Company, 220 U. S., 107; Billings v. United States, 232 U. S., 261.

The foregoing cases make it clear that there is a principle of constitutional law firmly established by this Court that a taxing law which imposes a tax based on a wholly arbitrary classification is void within the Fifth Amendment. To be sure in all the cases the Court found that the classification was not of that character. *But the discussion in all the cases is based on the implied assumption that if the classification were of that arbitrary character the law would be invalid.*

It must be admitted that this Court, when dealing with the Fifth Amendment and the question whether it has been violated by an Act of Congress, has used language of a more guarded character than when dealing with precisely the same question involving acts of state legislatures and the Fourteenth Amendment. But notwithstanding the greater care that this Court seems to have adopted when an Act of Congress was involved, in final analysis it seems clear that the function of this Court in dealing with a taxing law of Congress is precisely the same as when dealing with a taxing law of a state. And if a law passed by a state purporting to be a tax on income were of such a character that this Court would deem it a violation of

the "due process" clause in the Fourteenth Amendment, then we can not believe that this Court would come to any different conclusion under the Fifth Amendment when dealing with a precisely similar act of Congress.

In all the cases (of which the Brushaber case [240 U. S., 1] is an example) in which the contention has been made and been rejected by this Court, the decision of the Court was plainly correct, for in none of them was there anything which could possibly be considered to amount to arbitrary confiscation. In Knowlton v. Moore (178 U. S., 41), the Court modified the interpretation placed on the Act by the Department in order to avoid the claim of want of due process. In the Brushaber (240 U. S., 1) case the Court upheld the exemptions and the progressive features of the tax because of the historic precedents for such features. But the Act now before the Court makes the amount of the tax depend upon the accidental circumstance of the cost of property and not upon values. The result is that hardly any two taxpayers although their circumstances in other respects may be precisely the same will be taxed on the same principle.

(2) The due process clause in the Fifth Amendment means the same thing as the due process clause in the Fourteenth Amendment.

In Carroll v. Greenwich Insurance Company of New York, 199 U. S., 401, the Court said:

> "While we need not affirm that in no instance could a distinction be taken, ordinarily if an act of Congress is valid under the 5th Amendment it would be hard to say that a state law in like terms was void under the 14th." (410.)

Conversely, if a law passed by a state is void under the Fourteenth Amendment, a similar law passed by Congress would be void under the Fifth Amendment.

In Tonawanda v. Lyon, 181 U. S., 389, the Court, speaking of the Fourteenth Amendment said:

> *"The purpose of that amendment is to extend to the citizens and residents of the states the same protection against arbitrary state legislation affecting life, liberty and property, as is afforded by the 5th Amendment against similar legislation by Congress."* (392.)

Justice Harlan in dissenting in the result reached in this case, nevertheless said with reference to above doctrine:

> "I assent most cordially to this view, and therefore in another case, felt obliged to express my objection to the intimation that possibly that might be done by Congress under the due process clause of the 5th Amendment which could not be done by a state under the same clause of the 14th Amendment." (393.)

In French v. Barber Asphalt Paving Company, 181 U. S., 324 the Court said:

> "However, we shall not attempt to define what it is for a state to deprive a person of life, liberty or property, without due process of law, in terms which would cover every exercise of power thus forbidden to the state, and exclude those which are not, but shall proceed, in the present case, on the assumption that the legal import of the phrase 'due process of law' is the same in both amendments. *Certainly, it cannot be supposed that by the 14th Amendment it was intended to impose on the states, when exercising their powers of taxation, any more rigid or stricter curb than that imposed on the Federal Government, in a similar exercise of power, by the 5th Amendment.*"

And in Flint v. Stone Tracy Co., 220 U. S., 107, the Court referred to cases under the Fourteenth Amendment and assumed that they were applicable to the question of whether the excise law exceeded the provisions of the Fifth Amendment.

In Hibben v. Smith, 191 U. S., 310, the Court in discussing a state law levying a tax said:

> " * * * The 14th Amendment, it has been held, legitimately operates to extend to the citizens and residents of the states the same protection against arbitrary state legislation affecting life, liberty, and property as is of-

> fered by the 5th Amendment against similar legislation by Congress; but that the Federal Courts ought not to interfere when what is complained of amounts to the enforcement of the laws of a state applicable to all persons in like circumstances and conditions, and that the Federal Courts should not interfere *unless there is some abuse of law amounting to confiscation of property* or a deprivation of personal rights, such as existed in the case of Norwood v. Baker, 172 U. S., 269, 43 L. ed., 443, 19 Sup. Ct. Rep., 187." (325, 326.)

The cases last above cited under which the "due process" clause in the Fourteenth Amendment is interpreted are directly applicable in interpreting the due process clause in the Fifth Amendment because this Court has said that the requirements of the Fifth Amendment and the Fourteenth Amendment in this respect are the same. Therefore, the above cases and the ones still to be referred to in which this Court has held state statutes invalid under the Fourteenth Amendment are directly in point under the Fifth Amendment. And if we can show that the circumstances are substantially the same, namely, that the claimant in this case has been subjected to a wholly arbitrary, unequal exaction under the guise of a tax, of the same character as that imposed upon the complaining parties in the cases cited then we say that this Court must hold these cases, decided under the Fourteenth Amendment, directly in

point with the case at bar and that the principles announced in those cases are applicable in the present case.

(3) In Gast Realty & Investment Company v. Schenider Granite Company, 240 U. S. 55, and in other cases in this Court, tax laws of states have been held so arbitrary and baseless as to violate the Fourteenth Amendment.

In Looney v. Crane Co., 245 U. S. 178, it was held that a Texas statute which imposed a tax on the entire property of a corporation "exerted the taxing authority of the state over property and rights which were wholly beyond the confines of the state and not subject to its jurisdiction and therefore constituted a taking without due process." To the same effect see International Paper Company v. Massachusetts, 246 U. S. 135.

Let us consider the meaning of these two cases last cited. Just why could not the State of Texas or the State of Massachusetts levy these taxes? Although the Court said that these states were taxing property beyond their confines obviously that was not the fact because it was physically impossible. What these states were attempting was to levy a tax on property within the state which tax was to be measured by the extent of property outside the state. Now why did this Court hold that to be invalid? The reason is that it was a wholly arbitrary method of fixing the tax. To say that the

tax on the property of one corporation should be much greater than on the property of another, simply because the first company also owned property outside the state is, of course, arbitrary.

But it is no more arbitrary than (in fact, it is very similar to) the law now being considered which attempts to make the tax upon income depend not upon the size of the income or the value of the property from which the income is derived but upon the *cost* of the property which in our case is less than 2 per cent of its present value.

Southern R. Co. v. Greene, 216 U. S., 400, was a case where the State of Alabama after a foreign corporation had been admitted to do business attempted to levy a tax upon it at a rate different from the rate applicable to domestic corporations. The Court held that this violated the Fourteenth Amendment.

Gast Realty & Investment Company v. Schneider Granite Company, 240 U. S., 55, is an illuminating case. The case concerned the validity, under the Fourteenth Amendment, of the charter of the City of St. Louis, which provided that street improvements should be paid for by a tax on the abutting property. In case of subdivided property the tax was spread only on the lot abutting on the street, while unsubdivided property was taxed as far back as a line drawn half way to the next parallel or converging street. The effect of this law was to create a highly irregular district, the line in some places running back only 100 feet while the prop-

erty of the taxpayer in question was included to a depth of between 400 and 500 feet.

The Court, after stating that a state tax should not be held contrary to the Fourteenth Amendment "unless its action is palpably arbitrary or a plain abuse" concluded:

> "But, as is implied by Houck v. Little River Drainage Dist., if the law is of such a character that there is no reasonable presumption that substantial justice generally will be done, but the probability is that the parties will be taxed disproportionately to each other and to the benefit conferred, the law cannot stand against the complaint of one so taxed in fact. * * *" (58, 59)

> "The differences were not based upon any consideration of difference in the benefits conferred, but were established mechanically in obedience to the criteria that the charter directed to be applied. *The defendants' case is not an incidental result of a rule that, as a whole and on the average, may be expected to work well, but of an ordinance that is a farrago of irrational irregularities throughout. It is enough to say that the ordinance following the orders of the charter is bad upon its face as distributing a local tax in grossly unequal proportions, not because of special considerations applicable to the parcels taxed, but in blind obedience to a rule that requires the result.*" * * * (59)